



Defined Contribution  
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# Sustainable Investing in Defined Contribution Plans

## A Guide for Plan Sponsors

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### KEY TAKEAWAYS

- This paper seeks to provide plan sponsors with a base level of knowledge about sustainable investing and integration, by providing clarification on terminology and focusing on areas that historically have been misperceived.
- Historically, ESG-related investing was typically a trademark of socially focused collectives and unions. Sustainable investing today is affiliated with more than just values-based organizations, and it is increasingly independent of moral stances.
- The case for integrating ESG factors into the investment decision-making process is supported by both academic and industry research.
- DC plan participants are interested in seeing their investments aligned with their perceptions of long-term risk and value.
- The recent series of bulletins issued by the DOL has led to confusion due to a lack of clarity in the language and an inconsistent tone over the course of different administrations. However, the latest Field Assistance Bulletin, (FAB) 2018-01, issued in April 2018 maintains the analytical architecture of IB-2015 and IB-2016, and indicates that ESG factors remain an appropriate component of a prudent investment decision.
- The two primary ways for plan sponsors to implement sustainable investing in DC plans are 1) adding ESG-themed fund options into the fund lineup or self-directed brokerage window, and 2) considering ESG factor integration in investment processes during manager evaluation.

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## I. INTRODUCTION

When making investment decisions, institutional investors generally seek to ensure that all relevant material information is considered in order to maximize their ability to achieve risk-adjusted returns. Thanks to advances in data reporting and technology, investors have better access to such relevant material information. As a result, environmental, social and governance (ESG) considerations have increasingly become a part of the investment process. These “sustainability” considerations are no longer limited to a single impact or thematic fund, but can be integrated into most, if not all, investment strategies. Asset managers are striving to clearly communicate, and document if necessary, how ESG factors impact their overall investment decision-making process. Along these lines, fiduciaries are seeking best practices guidance on sustainable investing, including guidance on offering an ESG-themed fund and the integration of ESG factors.

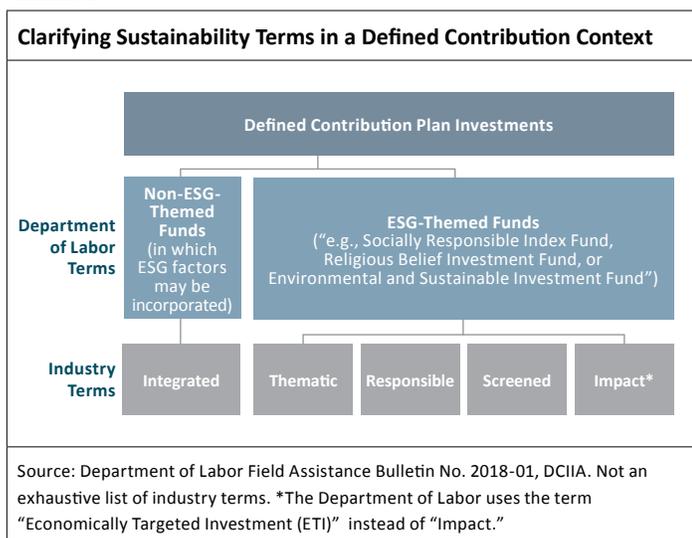
As the first in a series of best practices guides on sustainable investing within defined contribution (DC) plans, this paper seeks to provide plan sponsors with a base level of knowledge about sustainable investing and integration, by focusing on areas that have historically been misperceived. In an effort to promote further thought leadership on sustainable investing, this paper addresses sustainable investing fundamentals, the investment case, fiduciary responsibility, and DC implementation options.

## II. SUSTAINABLE INVESTING FUNDAMENTALS

**Clarification:** Many terms are used in the sustainable investing discussion. In this paper, we use “sustainable investing” as an umbrella term and distinguish ESG integration from ESG-themed funds. A glossary of terms is provided on page 7.

Sustainable investing is a framework for investors to examine companies from the perspective of long-term viability and ethical impact. This framework allows investors to evaluate a company’s exposure to, and ability to address, ESG-related risks and opportunities. In practice, sustainable investing can take many shapes along a spectrum focusing on financial and social benefits. A myriad of labels can therefore fall under the ESG umbrella, including: integrated, responsible, impact and other terms (Exhibit 1). While such classifications are intended as a helpful way of conveying where a particular investment strategy falls on the ESG spectrum, the multitude of labels can be confusing.

Exhibit 1



A bit of history can provide helpful context for understanding how sustainable investing has evolved. The foundations of sustainable investing generally date back to the 1960s, when shareholder activism, divestment and impact investing became trademarks of responsible investing. The Vietnam War spurred activists to attempt to persuade investors to divest holdings of Dow Chemical, the producer of napalm. Around the same time, unions recognized the potential to create wider social impact by investing in affordable housing and health facilities.

It was not until the 1980s that the institutional investment community took collective action. The creation of the Council of Institutional Investors (CII) in 1985 marked an important milestone. CII was the first group of large institutional investors to take an activist investor approach around governance, organizing to influence the companies that its members invested in, through proxy voting, shareholder resolutions, discussions and litigation—its goal being to pressure regulatory bodies to increase transparency and market integrity in order to benefit their fund beneficiaries.<sup>1</sup> A number of events and issues have triggered divestment campaigns over time, such as South African apartheid, tobacco, and more recently private prisons, firearms manufacturers and retailers, and fossil fuels.

Historically, ESG-related investing was typically a trademark of socially focused collectives and unions. Today, sustainable investing is affiliated with more than just values-based organizations, and it is increasingly independent of moral stances. Instead, many modern investment approaches consider ESG factors in order to identify companies with the strongest prospect for long-term success, focusing on value, not values.

An investor can pursue a sustainable strategy anywhere along the spectrum: seeking strategies that integrate ESG factors from a risk/return perspective; looking for those that target specific social or environmental goals; or, incorporating elements from various approaches into one investment or program.

## III. THE ESG INVESTMENT CASE

**Myth #1:** There is insufficient research to support sustainable investing

The investment case for integrating ESG factors into the investment process is less ambiguous than previously perceived. Many academic and industry research studies provide a clear rationale for incorporating ESG factors into investment decision-making. Academic studies that have analyzed the relationship between ESG factors and performance have found a strong correlation with alpha, beta, and portfolio value.

The 2015 paper entitled “Corporate Sustainability: First Evidence on Materiality,” has become one of the most prominent research studies supporting ESG integration in investment decision making, with over 10,000 downloads from the Social Science Research Network (SSRN).<sup>2</sup> Using the Sustainability Accounting Standards Board (SASB) framework to identify material sustainability issues, the paper’s research team found that firms with good

performance on material sustainability issues significantly outperform (by measure of alpha) firms with poor performance on these issues.<sup>3</sup> In another study, researchers found that financial performance — as measured by a range of factors, including return on assets and return on equity — is strengthened when banks increase corporate social responsibility activities,<sup>4</sup> an ESG-related business practice.

Academic research also demonstrates that, relative to non-ESG-themed mutual funds, an ESG theme does not necessarily detract from mutual fund investment performance when measured by risk-adjusted alphas.<sup>5</sup> Moreover, studies have demonstrated positive benefits from ESG themes, such as improved net-of-fee performance relative to non-ESG-themed funds,<sup>6</sup> and increased portfolio value, when overweighting high-ESG-rated stocks without incorporating a values-based screening approach.<sup>7</sup>

Investment consultants, asset managers and data providers have also conducted industry research that supports alpha enhancement qualities. Cambridge Associates found that ESG ratings were a strong source of alpha for emerging markets equities.<sup>8</sup> Similarly, a meta-analysis commissioned by Deutsche Bank found positive relationships between ESG factors and financial performance.<sup>9</sup> MSCI also found strong support for ESG-factor integration: high-ESG rated companies generally demonstrated higher profitability, higher dividend yield and lower idiosyncratic tail risks.<sup>10</sup>

Further, industry researchers have studied the aggregated effects of ESG factors on fund performance. A 2017 research study by Morningstar found that mutual funds with a 5-globe Sustainability Rating (the highest possible score), when compared to 1-globe funds, have: better risk-adjusted returns relative to their category; less volatility; and greater exposure to financially healthy companies.<sup>11</sup>

While there is a great deal of research supporting ESG integration, it is true that some studies have been less enthusiastic. For example, a 2015 academic paper suggests that investors may no longer be able to benefit from any outperformance due to high ratings on ESG factors,<sup>12</sup> and a 2018 white paper focuses on some of the biases of ESG ratings, including capitalization, geography and industry.<sup>13</sup>

As research on the investment effects of sustainability continues to be developed, fiduciaries have expressed a desire to better understand how this research relates to their DC investment strategies. To access further resources supporting the investment case for sustainable investing, visit [DCIIA's Resource Library on Investment Options and Best Practices](#).

**Myth #2:** Plan participants are not interested in sustainable investing

Since the availability of ESG data is relatively new, and is not often marketed directly to participants, it is up to plan sponsors and investment managers to provide education and communication about how their DC investments would score when viewed through an ESG lens. Further, because these strategies have only recently become more mainstream, broad participant demand for ESG integration could be considered latent, versus weak. In other words, assets in ESG-themed mutual funds (\$526 billion in socially responsible<sup>14</sup>, of which \$161 billion were in ESG-integrated strategies, as of December 2018<sup>15</sup>) and the adoption of ESG-themed mutual funds within DC plans are not yet appropriate indicators of participant views on sustainable investing. (Overall, 8% of Vanguard recordkept DC plans offer a socially responsible fund, though there is a significant range, according to plan segment by participant count. Seven percent of plans with fewer than 500 employees offer a socially responsible fund, while 19% of plans with more than 5,000 employees offer a socially responsible fund.<sup>16</sup>)

When sustainability is framed as more than just ESG-themed funds, investors agree that these factors should be considered in their investment options:

- a 2014 survey by Morgan Stanley found that 7 in 10 investors were interested in sustainable investing;<sup>17</sup>
- a 2016 survey by Natixis found that 8 in 10 DC plan participants want their retirement plan investments to reflect their personal values;<sup>18</sup>
- a 2017 survey by Strooga Consulting found that 7 of 10 DC plan investors believed their employer to be aware of sustainability risk (defined as “risks related to doing business over generations, including climate change, reputation, and corporate governance”) in their 401(k) plan, and 8 in 10 said they would remain in an investment fund that incorporated sustainability risk if they were automatically enrolled in it.<sup>19</sup>

While a great deal of emphasis has been placed on millennials' and women's affinity for sustainable investment by the industry media, most surveys show that interest is consistent across many demographic segments.

#### IV. FIDUCIARY RESPONSIBILITY

**Myth #3:** Adding an ESG-themed fund or requiring ESG integration is incompatible with fiduciary responsibility

Plan sponsors look to the Department of Labor (DOL) to provide guidance on their fiduciary responsibility as it relates to any new development, and sustainable investing is no exception. However, the recent series of Interpretive Bulletins (IBs) issued by the DOL has led to confusion due to a lack of clarity in the language and an inconsistent tone over the course of different administrations.

To recap, IBs issued in 2015 and 2016 were regarded as clarifying the application of ERISA for this new dimension for plan fiduciaries — those who were considering ESG factors in their investment decisions, and engagement with corporations on those themes — in a manner consistent with ERISA’s fiduciary standards of prudence and loyalty.<sup>20</sup> In fact, the 2015 guidance makes clear that, “fiduciaries should appropriately consider factors that potentially influence risk and return,” and that “environmental, social, and governance issues may have a direct relationship to the economic value of a plan’s investment.” The bulletin states: “In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of economic merits of competing investment choices.”<sup>21</sup>

The latest Field Assistance Bulletin (FAB) 2018-01, issued in April 2018, seeks to establish high-level guardrails on the intent and costs involved in ESG factors and shareholder engagement. It states that “a fiduciary’s evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan’s articulated funding and investment objectives.”<sup>22</sup> It’s important to note, however, that the analytical architecture of IB-2015 and IB-2016 remains unchanged, and that ESG factors remain an appropriate component of a prudent investment decision.<sup>23</sup>

The 2018 bulletin also states that “a prudently selected, well managed, and properly diversified ESG-themed investment alternative could be added to the available investment options on a 401(k) plan platform without requiring the plan to forgo adding other non-ESG-themed investment options to the

platform.”<sup>24</sup> Lastly, the bulletin differentiates between ESG-themed funds and funds that incorporate ESG factors, when it comes to the selection of a qualified default investment alternative (QDIA). Plan sponsors, the bulletin says, may designate a fund that considers ESG factors as a QDIA, but only if this consideration is part of the economic analysis, as opposed to a collateral benefits analysis, because the latter could raise questions about the fiduciary’s adherence with ERISA’s duty of loyalty.

Finally, FAB 2018-01 was produced to supplement, rather than replace, the previous publications from the DOL, by outlining limitations to potentially more expansive interpretations of prior guidance (ones that more broadly permitted consideration of ESG factors when investing plan assets).<sup>25</sup>

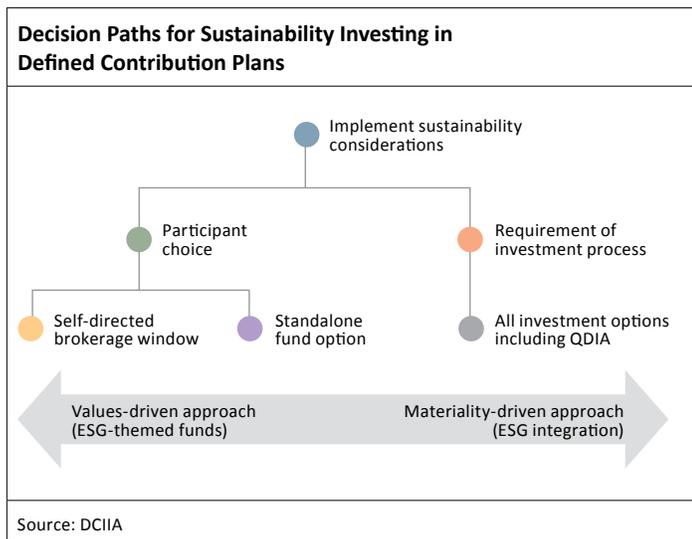
Susan Gary, a professor at the University of Oregon School of Law, suggests that beyond the question of whether a fiduciary may direct the use of ESG integration, a more critical question is whether they *should*. As more information about ESG factors has become available (as well as the commoditization of this information, via big data providers), they are increasingly incorporated into the financial analysis and investment decision-making process by asset managers. ESG factors can reveal risks and opportunities with financial consequences.<sup>26</sup> Professor Gary argues that evidence of materiality, combined with commoditization of ESG data, could put fiduciaries in breach of their duties of care should they *not* integrate ESG factors into their decision-making process.<sup>27</sup> While DCIIA appreciates this perspective, the absence of case law on the matter softens the urgency for ESG integration.

#### V. SUSTAINABLE INVESTING IMPLEMENTATION OPTIONS

**Myth #4:** Adding an ESG-themed fund in a DC plan and ESG integration are the same thing

While a growing number of institutional investors seek to integrate ESG criteria into their portfolios, unique challenges to doing so in participant-directed DC plans have emerged. There can be multiple access points to sustainable investing, including: the self-directed brokerage window; a standalone fund option on the core menu; or ESG integration within all fund options, including a plan’s default option, such as its QDIA.

Exhibit 2



Should a plan sponsor decide that implementing sustainability considerations is in the best interest of the plan's participants, the next decision for the sponsor is to identify the method(s) of implementation. The two primary ways for plan sponsors to implement sustainable investing in DC plans are 1) adding ESG-themed fund options into the fund lineup or self-directed brokerage window, and 2) considering ESG factor integration in investment processes during manager evaluation. In its 2018 list of priorities for DC plan sponsors, Mercer indicated that ESG factors are "critical risk factors that should be assessed by investment managers."<sup>28</sup> Once a sponsor has determined that it will add this dimension of consideration to its investment evaluations, such additions to the intent and the process should be reflected in the Investment Policy Statement or other comparable documentation maintained by the plan.

In terms of implementation, the two primary approaches are philosophically values- and materiality-driven:

**A values-driven approach** enables participants to actively opt into an ESG-themed fund, whether it's through a standalone fund option on the core menu or through their self-directed brokerage window (if available). In the core menu scenario, plan sponsors must follow the same process as they would for a non-ESG themed fund. All relevant investment characteristics must be considered and evaluated,

with the help of a plan adviser or consultant. The committee must deliberate and vote on this standalone fund, and then commence participant education and communication. As with any other core menu option, the process for adding a standalone ESG-themed fund can take several quarters to complete.

Considerations for the core menu option within a values-driven approach include: determination of an ESG theme that appeals to all, or most, plan participants; and whether the distribution of collateral benefits accrues fairly to all beneficiaries. In other words, do the collateral benefits of a certain ESG theme favor one demographic over another? Instead of a core menu option, fiduciaries may opt for the self-directed brokerage option.

**A materiality-driven approach** eliminates the need for active selection by the participant with an *a priori* decision by the fiduciary that material ESG factors should be a part of the investment process. This approach requires ESG integration into the investment process for all funds. A determination to take this approach comes from a thorough understanding of how ESG factors can be material in investment decision-making. Modification of best practice plan documents, including the Investment Policy Statement, in order to acknowledge ESG factors may be a part of the materiality-driven approach.

A growing number of leading asset managers are taking this approach. In fact, over 2,000 organizations, more than 300 of which are U.S.-headquartered investment managers, are signatories of the Principles for Responsible Investment (PRI), the world's leading proponent of responsible investing.<sup>29</sup> The PRI provides guidance on how institutional investors can integrate ESG into their asset management processes. While ESG factors are increasingly becoming a focus for many large asset managers, the industry still needs to adopt best practice standards.

Fiduciaries can turn to outside research providers to assess the level of integration within their portfolios. Organizations such as MSCI, Sustainalytics and Institutional Shareholder Services (ISS) provide investors with ESG research and ratings to gauge how companies are managing ESG risks, which can be used to then evaluate the funds in a DC lineup. Finally, the SASB provides a useful framework that can be used as a guide to identify material sustainability issues.<sup>30</sup>

## VI. NEXT STEPS

Every plan sponsor has a different starting point for ESG integration, which means that each plan sponsor has a unique next step to take. For plan sponsors new to sustainable investing, circulating this report within the investment committee will help to set the groundwork for future discussions. [DCIIA's Resource Library on Investment Options and Best Practices](#) is also available as a tool for plan sponsors interested in learning more about the investment case for sustainable investing. A baseline knowledge of ESG factors can lead to a more in-depth dialogue with investment managers, plan consultants and

advisors. Discussing sustainability with service providers can help plan sponsors evaluate which implementation options best fit their plan. For plan sponsors with a more advanced understanding of sustainable investing, one next step could include if and how plan documents should be amended to integrate ESG factors.

DCIIA strives to be a trusted resource on sustainable investing within DC plans. We welcome feedback from retirement industry stakeholders as we continue our journey of documenting institutional best practices and promoting thought leadership, with the aim of improving the retirement security of America's workers.

## GLOSSARY

**Economically targeted investment (ETI)** – the Department of Labor's term used to describe impact investing.

**Environmental, social and governance (ESG) investing** – often used as an umbrella term to describe responsible investing, sustainable investing, or investing that integrates environmental, social and governance factors into decisionmaking.

**ESG integration** – systematically including relevant environmental, social and governance factors into securities analysis alongside other traditional financial metrics (e.g., P/E ratio). ESG factors focus on materiality for a sector or industry (e.g., data security is more relevant to banking than to agriculture) and contribute to an investment's risk/return outlook.

**ESG-themed investing** – a top-down investment approach that enables investors to gain positive exposure to macro themes (e.g., diversity, climate change) through their investments. For pooled vehicles, the stated investment objective or investment strategy explicitly describes an environmental, social or governance theme. Aims for optimal risk/return outcome for investments in relevant sectors to targeted theme.

**Impact investing** – investments made with the primary goal of fostering a specific positive social or environmental change, and that also seek to earn the investor a positive return. Goal is to maximize social or other benefits, with risk/return as a secondary goal.

**Long-termism** – an investment approach or philosophy that seeks to generate returns beyond traditional 10-, 20-, or 30-year time horizons.

**Non-ESG-themed investing** – any investment that does not explicitly describe an environmental, social or governance theme in investment objective or strategy. May or may not integrate ESG factors into the investment process.

**Responsible investing** – often used as an umbrella term to describe sustainable investing and ESG investing; an investment philosophy which seeks to generate both financial and social value.

**Screened investing** – the concept of aligning social and investment goals by pursuing or eliminating certain types of securities from investment portfolios (e.g., remove tobacco company securities from an S&P 500 Index fund). A screened approach can introduce significant tracking error relative to traditional investments.

**Sustainable investing** – often used as an umbrella term to describe responsible investing and ESG investing; an investment philosophy which seeks to generate both financial and social value.

**Values-based investing** – an investment philosophy that seeks to generate both financial and social value, primarily oriented to the morals and principles of the end-investor.

## Endnotes

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## ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of America's workers. To do this, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution outcomes. DCIIA's diverse group of members include investment managers, consultants and advisors, law firms, record keepers, insurance companies, plan sponsors and other thought leaders who are collectively committed to the best interests of plan participants.

For more information, visit: [www.dciia.org](http://www.dciia.org).

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